

Real Property: Cancellation of Debt and Foreclosure

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Cancellation of Debt

- Economic benefit
- Gross income includes income from cancellation of debt (COD)

Exceptions

- Gifts
- Deductible debt
- Price reduced after purchase

Recourse Debt

- Debtor personally responsible to repay the loan
- COD income =
 Debt Balance
 Less: Fair Market Value

Nonrecourse Debt

- Debtor NOT personally responsible to repay loan
 - Loan secured only by the property
- Generally no COD income

Form 1099-C

- Issued by lender
- \$600 or more of COD
- Debt discharged in Box 2



Exclusions under IRC 108

- Bankruptcy
- Insolvency
- Qualified Principal Residence Indebtedness

Bankruptcy Exclusion

- Title 11 Case
 - Includes Chapters 7, 11, 13
- Discharge granted by the court
- Discharge under a plan approved by the court

Insolvency Exclusion

- Exclusion applies to the extent of insolvency
- Insolvency calculation:
Total liabilities before the discharge
Less: FMV of total assets before the discharge
= Extent of insolvency

Insolvency Example

Debt Balance	\$220,000
Less: FMV of Personal Residence	<u>(200,000)</u>
Equals: Ordinary COD Income	20,000
Total Liabilities	\$240,000
Less: FMV of Assets	<u>(235,000)</u>
Equals: Extent of Insolvency	5,000



Qualified Principal Residence Indebtedness Exclusion

- Mortgage Debt Relief Act of 2007
- Exclusion related to restructuring and cancellation of qualified principal residence debt
- Tax Years 2007 through 2012

Qualifications

- Principal residence
- Debt must be secured by that residence
- Debt used to acquire, construct or substantially improve

Limitations

- Qualifying debt up to \$2 Million
- Qualifying debt up to \$1 Million for MFS
- Discharge related to:
 - Decline in value of the home, or
 - Decline in homeowner's financial position



No Exclusion For

- Second home
- Rental or investment property
- Business property
- Debt NOT used to acquire, construct or substantially improve the residence
- Closing costs rolled into the debt when refinanced

Only Part of Loan Qualifies

$$\begin{array}{r} \text{Canceled debt} \\ \text{Less: } \underline{\text{Non qualified debt}} \\ \hline = \text{Amount of Exclusion} \end{array}$$

Qualified Principal Residence Exclusion Example

Debt Balance	\$ 850,000
Less: FMV	<u>(735,000)</u>
Canceled Debt	115,000
Less: Non-Qualified Debt	<u>(110,000)</u>
Exclusion	<u>5,000</u>



Ownership of Home Retained

- Ownership of home retained after cancellation of qualified debt
- Reduce basis of residence by amount excluded – but not below zero
- Enter reduction on Line 10b of Form 982

Other Exclusions under IRC 108

- Qualified farm indebtedness
- Qualified real property business indebtedness

Reduction of Tax Attributes

1. Net operating losses
2. General business credits
3. Minimum tax credit
4. Capital loss



Reduction of Tax Attributes

- 5. Basis in property
- 6. Passive activity loss and credits
- 7. Foreign tax credit



Form 982

- Report COD exclusion
- Report amount excluded
- Reduction of Tax Attributes

Foreclosure Consequences

- Gain or loss from the disposition of the property
- Cancellation of debt income (if recourse debt)

Foreclosure Consequences Nonrecourse Debt

- No COD Income
- Gain or loss =
Debt Balance
Less: Adjusted Basis

Foreclosure Example

Nonrecourse Debt

Debt balance	\$180,000
Less: Adjusted basis	<u>(175,000)</u>
Equals: Gain from foreclosure	<u>5,000</u>

Foreclosure Consequences Recourse Debt

COD Income =

Debt balance

Less: Fair Market Value

Gain or loss =

FMV (limited to debt balance)

Less: Adjusted basis



Foreclosure Example

Recourse Debt

Debt balance	\$180,000
Less: FMV of personal residence	<u>(170,000)</u>
Equals: Ordinary COD income	<u>10,000</u>
FMV of personal residence	\$170,000
Less: Adjusted basis	<u>(200,000)</u>
Equals: Nondeductible loss on foreclosure	<u>(30,000)</u>

Form 1099-A

- Foreclosure or repossession
- Debt balance outstanding in Box 2
- FMV of property in Box 4

Personal Residence

- COD income may be excludible
 - Bankruptcy
 - Insolvency
 - Qualified principal residence
- Gain from foreclosure may be excludible
 - Principal residence
- Loss from foreclosure not deductible

Rental Property

- COD income may be excludible
 - Bankruptcy
 - Insolvency
- Reduction of tax attributes
- Gain or loss from foreclosure reported on Form 4797

Investment Property

- COD income may be excludible
 - Bankruptcy
 - Insolvency
- Reduction of tax attributes
- Gain or loss from foreclosure reported on Form 8949 - Schedule D

Real Estate Tax Center

- Tax Tips
- Avoiding Problems
- Trends and Statistics
- Related Links
- Tips on Rental Real Estate Income, Deductions and Recordkeeping



Additional Resources

- Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments
- Publication 544, Sales and Other Dispositions of Assets
- Publication 523, Selling Your Home

Summary

- Cancellation of debt creates income
- IRC 108 may allow for the exclusion of COD income
- Tax attributes must be reduced when COD income is excluded

Summary (cont.)

- Foreclosure results in a gain or loss as if the property was sold
- Exclusions do not apply to gain from foreclosure

Summary (cont.)

- Recourse debt:
 - Cancellation of debt income
 - Gain or loss from foreclosure
- Nonrecourse debt:
 - Gain or loss from foreclosure

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